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**Changes in Accounting for Negative Goodwill:  
New Insights into Bargain Purchase Transactions  
*Why Sell for Less Than Fair Value?***

**Executive Summary**

SFAS 141(R), *Business Combinations*, includes significant changes to the accounting and disclosure requirements for acquisitions made at less than fair value. Under new rules, acquisition-related gains, asset valuations and shareholders' equity will be higher in transactions yielding negative goodwill, a financial statement element referred to henceforth as a bargain purchase amount. In years after the acquisition, operating earnings will be reduced as increased asset valuations are amortized or depreciated.

Disclosure requirements contained in the revised standard provide financial statement readers with new insights into why firms are able to effect acquisitions at less than fair value. In reviewing 71 acquisitions, we find several reasons for the existence of such bargain purchase gains, ranging from financial distress of the target, to special characteristics of the acquiring firm, to flaws in the bidding process. These findings have implications for investors, who must analyze bargain purchase transactions, for CFOs and other corporate managers, who must implement the new standard's provisions, and for regulators, who must determine whether the new standard is being properly applied.

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**Georgia Tech Financial Analysis Lab  
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**Georgia Tech Financial Analysis Lab**

The Georgia Tech Financial Analysis Lab conducts unbiased stock market research. Unbiased information is vital to effective investment decision-making. Accordingly, independent research organizations, such as this Lab, have an important role to play in providing information to market participants.

Because the Lab is housed within a university, all of its research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Its focus is on issues that it believes will be of interest to a large segment of stock market participants. Depending on the issue, the Lab may focus its attention on individual companies, groups of companies, or on large segments of the market at large.

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**Changes in Accounting for Negative Goodwill:  
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**By Eugene E. Comiskey and Charles W. Mulford**

**Introduction**

In 2009 we saw important changes to the accounting for acquisitions entailing negative goodwill. In these transactions, the fair value of the net assets acquired in a business combination exceeds the purchase price. In effect, the business is acquired for less than its fair value – a bargain. Historically, the reasons for such bargain purchase transactions typically were not provided and the financial statement effects were not particularly clear. With changes introduced by SFAS No. 141(R), *Business Combinations*, such financial statement shortcomings have now been addressed.<sup>1</sup> Disclosures made by firms accounting for business combinations under the new reporting standard provide useful insight into the reasons for and the financial statement effects of bargain purchase transactions.

Under previous accounting guidance, negative goodwill, or the amount by which the fair value of net assets acquired exceeded the purchase price, was first used to reduce the fair values assigned to certain acquired assets. These assets, referred to as allocation assets, were typically more difficult to value and included mostly noncurrent, non-financial assets such as land, buildings, equipment and intangibles. In effect, the thinking at the time was not to accept, at face value, the existence of a bargain purchase, but rather to treat it as an accounting fiction that arose because of an improper valuation of certain hard-to-value assets. No gain on the transaction was recorded unless the amount of the bargain purchase exceeded the fair values of all such allocation assets. Then, in accounting for the acquisition, the values assigned to those difficult-to-value assets would be reduced to zero and a gain would be recorded for any remaining bargain purchase amount.

While no gain was recorded in the year of acquisition to the extent that allocation assets were reduced for the amount of any negative goodwill, that gain did find its way into income in future years. That is, lower asset values led to lower expense charges through reduced amortization or depreciation over time, raising operating income.

With the introduction of the revised version of SFAS No. 141, there is no longer any allocation of negative goodwill, which is now officially referred to as the bargain purchase amount, against allocation assets. Rather, now the entire bargain-purchase amount is reported as a gain on the income statement and is treated as a component of earnings before extraordinary items.<sup>2</sup>

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<sup>1</sup> Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combinations*, (Norwalk, CT: Financial Accounting Standards Board, December, 2007). The content of the accounting standard is contained in Topic 805, Business Combinations, of the FASB Accounting Standards Codification.

<sup>2</sup> For more background on the treatment of negative goodwill (bargain purchases) over the years, see Eugene E. Comiskey and Charles W. Mulford. 2008. Negative Goodwill: Issues of Financial Reporting and Analysis Under Current and Proposed Guidelines. *The Journal of Applied Research in Accounting and Finance* 3 (1): 33-42.

The revised SFAS No. 141 became effective for business combinations completed during annual reporting periods that begin on or after December 15, 2008.<sup>3</sup> In effect, first adopters are mainly calendar-year reporting firms in 2009.

In adopting the new accounting standard, firms with acquisitions involving bargain-purchase gains will likely see increases in earnings that may be substantial. In addition, because any bargain purchase amounts will not be used to reduce the valuations of allocation assets, assets and shareholders' equity of acquired firms will be valued at higher amounts. Correspondingly, through increased amortization of these higher asset valuations, (including increased depreciation of revalued fixed assets), earnings will be reduced in years following the acquisition. In effect, higher up-front gains that are clearly viewed as nonrecurring will replace higher future operating income.

Beyond the effects on earnings, assets and shareholders' equity due to revisions in the accounting for bargain purchase transactions, increased disclosure requirements will provide substantial increases in disclosures of the reason(s) for bargain purchase transactions. Investors and analysts tend to be skeptical of the existence of bargain purchases. Why would a firm's management be willing to sell a business for a purchase price that is less than the fair value of its net assets? Why not sell the assets off piece-meal and reap the bargain purchase amount for the shareholders of the selling firm? In theory, disclosures provided under the new accounting standard should provide answers to such questions.

### ***Purpose***

The purpose of this research report is to highlight the changes that have occurred to accounting and disclosure requirements for bargain purchase acquisition transactions. Investors will want to take note because of the new standard's effects on earnings and financial position. New disclosures of the reasons for a bargain purchase will provide useful insight into why the acquiring firm was able to effect a purchase transaction at a bargain price. Armed with such insight, investors should be better equipped to evaluate the likelihood of future success of the target's operations. CFOs and other corporate managers will find useful insight into how others are applying the new reporting and disclosure requirements. These managers should be prepared to report higher, up-front gains in the year of acquisition that analysts consider nonrecurring, while anticipating a drag on future operating income as higher asset valuations lead to increased amortization expense. Disclosures of reasons for the existence of bargain purchases should provide them with a better understanding of crosscurrents impacting their industry. Accounting regulators will also find the results of this study to be informative as they seek to obtain data on how companies are applying the new accounting standard.

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<sup>3</sup> SFAS No. 141(R), page vi.

## Accounting for Bargain Purchase Transactions under Previous Standards

### *No Up-front Gain Reported*

As an example of a business combination accounted for under previous accounting standards, consider the 2007 acquisition of Samsung Corning Co., Ltd., (SSC) by Corning, Inc., described below. Including \$591,000 in direct acquisition costs, Corning paid \$315,029,000 for SSC.<sup>4</sup>

As reported by the company<sup>5</sup>:

On December 31, 2007, the Company acquired all of the outstanding securities of SSC in exchange for 217,462 shares of the Company's common stock and 107 shares of the Company's preferred stock (the Acquisition). The transaction was accounted for as a business combination.

The aggregate purchase consideration has been allocated to the assets and liabilities acquired, including identifiable intangible assets, based on their respective estimated fair values. The respective estimated fair values were determined by a third-party appraisal at the acquisition date, and resulted in excess fair value of the net assets acquired over the purchase consideration of \$33,763 thousand. The negative goodwill of \$33,763 thousand was allocated on a pro rata basis to all of the acquired assets except financial assets, assets to be disposed of by sale, deferred tax assets and other current assets.

A summary of the allocation of the purchase price is as follows:

*(in thousands)*

Current assets	\$ 317,978
Equity investments	2,184
Property, plant and equipment, net	142,961
Intangible assets	4,479
Other non-current assets	40,342
Current liabilities	(151,402)
Accrued severance benefits, net	(6,567)
Minority interest in consolidated subsidiaries	(30,846)
Foreign currency translation adjustment	(4,100)
 Net assets acquired	 \$ 315,029

In the above display, Corning reports that the fair value of the net assets received in the acquisition exceeded the purchase price, resulting in negative goodwill of \$33,763,000. That is, the fair value of acquired net assets, derived by a third-party appraisal at the acquisition date, exceeded the purchase price by \$33,763,000. Thus, the fair value of the acquired net assets must have been \$348,792,000 (\$315,029,000 + \$33,763,000). However, as noted, the net assets acquired were recorded at the acquisition price of \$315,029,000. Accordingly, the

<sup>4</sup> Under SFAS 141(R), acquisition costs are expensed.

<sup>5</sup> Corning, Inc., SEC Form 10-K Annual Report, December 31, 2007, p. 152.



negative goodwill of \$33,763,000 was fully deducted from the fair values of allocation assets, i.e., property, plant and equipment, intangible assets and other non-current assets, resulting in the final recording of the acquisition at its purchase price of \$315,029,000, and not at fair value. In the Corning acquisition, no gain was recorded even though there was negative goodwill. Had the amount of negative goodwill exceeded the allocation assets, then an extraordinary gain would have been recorded for that excess.

Even though no explicit gain on the bargain purchase transaction was recorded at the time of acquisition, there was an implicit gain for the bargain purchase amount. However, rather than being recorded at the time of the acquisition, that gain would find its way to the income statement in future periods through the reduced amortization of allocation assets. That is, because certain assets are recorded at amounts lower than fair value, the bargain purchase gain was effectively metered into income over future reporting periods. Historically, investors could have been misled by the lack of disclosure of these gains in future periods. They may have ascribed to them a certain recurring quality when, in fact, they were derived from a non-recurring source. In effect, a nonrecurring gain was made to appear as though it had a recurring quality.

Corning gave no reason why they were able to acquire SSC for a bargain price. Knowing the reason would help investors better understand the business of the target and its future prospects.

Under new accounting rules provided by SFAS No. 141(R), *Business Combinations*, Corning would have recorded all acquired assets at their fair value, regardless of the acquisition price. So the net assets would have been recorded at \$348,792,000 and a non-extraordinary gain of \$33,763,000 (ignoring direct acquisition costs of \$591,000, which would have been expensed) would have been recorded at the time of acquisition. Future amortization expense would have been higher as assets carrying higher valuations were expensed over time.

### ***Partial Up-front Gain Reported***

As another example of a bargain purchase transaction recorded under previous accounting guidelines, consider the acquisition of Washington Mutual Bank by JPMorgan Chase & Co. While this transaction resulted in a significant amount of negative goodwill, much of that bargain purchase amount was somewhat hidden from view.

On September 25, 2008, JP Morgan paid \$1.9 billion to acquire the banking operations of Washington Mutual. As a result of the transaction, JPMorgan recorded an extraordinary gain of \$1.9 billion related to negative goodwill. (It is only coincidental that the purchase price and the amount of the extraordinary gain are the same). That gain was prominently displayed on JP Morgan's income statement for 2008. However, in a footnote to the financial statements, the company provided the following disclosure:

The acquisition was accounted for as a purchase business combination in accordance with SFAS 141. SFAS 141 requires the assets (including identifiable intangible assets) and liabilities (including executory contracts and



other commitments) of an acquired business as of the effective date of the acquisition to be recorded at their respective fair values and consolidated with those of JPMorgan Chase. The fair value of the net assets of Washington Mutual's banking operations exceeded the \$1.9 billion purchase price, resulting in negative goodwill. In accordance with SFAS 141, noncurrent, nonfinancial assets not held-for-sale, such as premises and equipment and other intangibles, were written down against the negative goodwill. The negative goodwill that remained after writing down transaction related core deposit intangibles of approximately \$4.9 billion and premises and equipment of approximately \$3.2 billion was recognized as an extraordinary gain of \$1.9 billion.<sup>6</sup>

In the note, the company discloses that there was a substantial bargain purchase amount related to the Washington Mutual acquisition. The company allocated that bargain purchase amount to certain noncurrent assets, such as premises and equipment and other intangibles, writing them down to zero in the process. The amounts of the write-downs were \$4.9 billion against core deposit intangibles and \$3.2 billion against premises and equipment. The remaining bargain purchase amount of \$1.9 billion was recognized as an extraordinary gain.

Just to be clear, the total amount of negative goodwill related to the JPMorgan acquisition of Washington Mutual was \$10 billion (\$4.9 billion for core deposit intangibles, \$3.2 billion for premises and equipment and a \$1.9 billion remainder). The company recorded a \$1.9 billion extraordinary gain in the year of acquisition and will meter the remaining \$8.1 billion of gain, the amount by which the recorded values of the core deposit intangible and the premises and equipment assets were reduced, into income in future years through reduced amortization. As a result, \$8.1 billion of nonrecurring gain takes on the appearance of a more recurring quality.

### **Accounting for Bargain Purchase Transactions under Current Standards**

The key change under SFAS 141(R) is that negative goodwill is no longer allocated to reduce the carrying value of non-current and non-financial acquired assets. Rather, the entire amount of any bargain purchase is treated as income and recorded as an ordinary (i.e., not extraordinary) gain. The longstanding position that negative goodwill is largely the product of over-valued acquired assets appears to be history. This change is no doubt supported in part by a key feature of the new standard that calls for acquiring firms to challenge initial computations that suggest a bargain purchase:

Before recognizing a gain on a bargain purchase, the acquirer shall reassess whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review. The acquirer shall then review the procedures used to measure the amounts this Statement requires to be recognized at the acquisition date. . . .<sup>7</sup>

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<sup>6</sup> JPMorgan Chase & Co., Form 10-K Annual Report, December 31, 2008, p. 123.

<sup>7</sup> SFAS No. 141(R), paragraph. 38.

In other words, before recognizing a bargain purchase gain related to an acquisition, the new standard is imploring managers to carefully identify and detail all acquired assets and liabilities. Examples of recent acquisitions involving bargain purchase amounts accounted for in accordance with these new rules are provided below.<sup>8</sup>

***Alamo Group Acquisition of Bush Hog, LLC***

In 2009, the Alamo Group acquired the operations of Bush Hog, LLC. The company describes the transaction as follows:

On October 22, 2009 (“Closing Date”), the Company acquired the majority of the assets and assumed certain liabilities of the Bush Hog, LLC, a Delaware limited liability company (“*Bush Hog*”) located in Selma, Alabama. The purchase included substantially all of the ongoing business of *Bush Hog*, including the *Bush Hog* brand name and all related product names and trademarks (the “Acquisition”). The purchase price consideration was 1.7 million unregistered shares of Alamo Group common stock which represented approximately 14.5% of the outstanding stock of Alamo Group. The closing price on October 22, 2009 was \$16.09 per share.

The fair value of the net assets acquired was approximately \$53.1 million, which exceeds the preliminary estimated purchase price of \$25.4 million. Accordingly, the Company recognized the excess of the fair value of the net assets over the purchase price of approximately \$27.7 million as a gain on bargain purchase. The gain on bargain purchase of \$27.7 million is shown separately within income from operations in the Consolidated Statements of Income. The recorded amounts are provisional and subject to change. The Company continues to evaluate the purchase price allocation, including the opening fair value of inventory, accounts receivable, property, plant & equipment, accrued liabilities and deferred taxes, which may require the Company to adjust the recorded gain.<sup>9</sup>

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<sup>8</sup>Readers interested in additional examples of the effects on assets, shareholders’ equity and net income of new accounting standards for bargain purchase transactions should refer to the study by Comiskey and Mulford, *Negative Goodwill: Issues of Financial Reporting and Analysis Under Current and Proposed Guidelines*, (Georgia Tech Financial Analysis Lab, October 2007). The stock market’s reaction to bargain purchase acquisitions was examined in Comiskey, Clarke and Mulford, “Is Negative Goodwill Valued by Investors?” *Accounting Horizons*, September 2010, pp. 333-353.

<sup>9</sup>Alamo Group, SEC Form 10-K Annual Report, January 31, 2010, pp. 74-75.

According to disclosures provided by the company, the fair value of net assets acquired in the transaction, \$53.1 million, exceeded the purchase price of \$25.4 million by the bargain purchase amount of \$27.7 million. That \$27.7 million excess was reported by the company as a gain, interestingly, within income from operations. Excerpts of the company's income statement for 2009, with the gain prominently displayed, are provided below<sup>10</sup>:

**Alamo Group Inc. and Subsidiaries**  
**Consolidated Statements of Income**

**Year Ended December 31,**

(in thousands)	<b>2009</b>	<b>2008</b>	<b>2007</b>
Net sales:			
North American			
Industrial	\$ 173,905	\$ 254,787	\$ 253,203
Agricultural	92,415	120,232	117,652
European	180,167	182,116	133,531
Total net sales	446,487	557,135	504,386
Cost of sales	351,926	447,721	406,675
Gross profit	94,561	109,414	97,711
Selling, general and administrative expenses	76,099	83,059	73,874
Gain on bargain purchase	(27,689)	—	—
Goodwill impairment	14,104	5,010	—
Income from operations	32,047	21,345	23,837

Reporting the gain on bargain purchase as operating income seems to be somewhat of a stretch. Moreover, the gain comprised 86% of the company's 2009 operating income. However, because it is reported as a separate line item on the income statement, analysts would be easily able to identify the nonrecurring character of the gain.

Note too that the gain on bargain purchase is a non-cash gain. As such, on the company's statement of cash flows, the gain was subtracted from net income in deriving cash provided by operating activities. Further, except for \$828,000 in acquisition-related expenses, the entire acquisition was a non-cash transaction, paid for with Alamo shares. Accordingly, the acquisition does not appear in the investing section of Alamo's cash flow statement.

A summary of the assets and liabilities identified and the fair values assigned by the company are provided below<sup>11</sup>:

<sup>10</sup> Ibid., p. 46.

<sup>11</sup> Ibid., p. 74-75.

The following are estimated fair value of assets acquired and liabilities assumed as of the Acquisition date (in thousands):

Accounts receivable	\$ 25,571
Inventory	21,875
Prepaid expenses	395
Property, plant & equipment	12,743
Other liabilities	(9,357)
Net assets acquired	51,227
Intangible asset	
<i>Bush Hog</i> trade name	1,900
Total assets acquired	53,127
Less: Fair value of 1.7 million unregistered shares	25,438
Gain on Bargain purchase	\$ 27,689

Note that the company gives no mention of reducing the recorded fair values of any acquired assets. All acquired assets and liabilities are recorded at their fair value in the acquisition and the full amount of the excess, \$27,689,000 in this example, is reported as a gain. Under previous standards, the recorded gain would have been used to reduce the valuations assigned to property, plant & equipment (valued at \$12,743,000) and the intangible asset, the *Bush Hog* trade name (valued at \$1,900,000). As such, the valuations assigned to these so-called allocation assets and the gain would have been reduced by \$14,643,000 (\$12,743,000 + \$1,900,000). Ignoring income taxes, shareholders' equity would have been reduced by a similar amount.

In addition to the disclosures of the financial effects of the transaction, in line with the requirements of SFAS No. 141(R), the company provided an explanation for why it was able to acquire *Bush Hog* at a bargain purchase,

The Company believes that it was able to acquire *Bush Hog* for less than the fair value of its assets because of (i) the Company's unique position as a market leader in this industry segment and (ii) the seller's intent to exit its *Bush Hog* operations. *Bush Hog* was an unprofitable venture, and the seller approached the Company in an effort to sell *Bush Hog* and exit the agricultural equipment manufacturing business that no longer fit its strategy. With the seller's intent to exit the agricultural manufacturing business segment and the Company's position as a market leader, the Company was able to agree on a favorable purchase price.<sup>12</sup>

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<sup>12</sup> Ibid.

Apparently, the desire of Bush Hog to exit the agriculture manufacturing business was a key reason that made it possible for the Alamo Group, a market leader in this industry, to obtain a favorable purchase price.

A second example entails the acquisition of a commercial bank that was under financial duress. Bank acquisitions comprise a significant percentage of the bargain-purchase transactions observed during 2009.

### ***New York Community Bancorp Acquisition of AmTrust***

New York Community Bancorp, Inc. acquired AmTrust in an FDIC-assisted transaction. The summary of net assets acquired is provided below.<sup>13</sup>

A summary of the net assets acquired and the estimated fair value adjustments resulting in the net gain follows:

<i>(in thousands)</i>	<b>December 4, 2009</b>
AmTrust's cost basis liabilities in excess of assets	\$ (2,799,630)
Cash payments received from the FDIC	<u>3,220,650</u>
Net assets acquired before fair value adjustments	421,020
Fair value adjustments:	
Loans	(946,083)
FDIC loss share receivable	740,000
Core deposit intangible	40,797
FHLB borrowings	(69,814)
Repurchase agreements	(11,180)
Certificates of deposit	(26,858)
FDIC equity appreciation instrument	<u>(8,275)</u>
Pre-tax gain on the AmTrust acquisition	\$ 139,607
Deferred income tax liability	<u>(55,410)</u>
Net after-tax gain on the AmTrust acquisition	\$ 84,197

<sup>13</sup>New York Community Bancorp, Inc., SEC Form 10-K Annual Report, December 31, 2009, p. 108.

Unlike the Bush Hog transaction, the AmTrust acquisition entailed a cash payment received by the acquiring firm, New York Community Bancorp (NYCB). The cash payment came from the FDIC. Prior to the \$3.2 billion cash payment from the FDIC, NYCB had assumed liabilities that exceeded the carrying values of assets acquired by \$2,799.6 million. The cash payment received resulted in a net-asset acquisition position of \$421,020,000 at book value. Assets at book value must be adjusted to fair value before being recorded by the acquiring firm. The fair-value adjustments to various assets and liabilities are used to adjust the book values of the assets to fair value. The net result is a pretax bargain purchase gain of \$139,607,000, or \$84,197,000 on an after-tax basis.

New York Community Bancorp described the transaction as follows:

The net after-tax gain represents the excess of the estimated fair value of the assets acquired (including cash payments received from the FDIC) over the estimated fair value of the liabilities assumed and is influenced significantly by the FDIC-assisted transaction process. Under the FDIC-assisted transaction process, only certain assets and liabilities are transferred to the acquirer and, depending on the nature and amount of the acquirer's bid, the FDIC may be required to make a cash payment to the acquirer. As indicated in the preceding table, net liabilities of \$2.8 billion (i.e., the cost basis) were transferred to the Company in the AmTrust acquisition, and the FDIC made a cash payment to the Company of \$3.2 billion.<sup>14</sup>

In this statement, NYCB is clear in noting that the company was able to effect a bargain purchase because of the FDIC's involvement. That is, as noted by the company, “. . .the estimated fair value of the assets acquired (including cash payments received from the FDIC) over the estimated fair value of the liabilities assumed and is influenced significantly by the FDIC-assisted transaction process.”<sup>15</sup> In other words, New York City Bancorp was able to purchase AmTrust for less than the fair value of its net assets because of the FDIC's role.

### **Company Disclosures of Reasons for Their Bargain Purchases**

As noted, SFAS 141(R) requires disclosure of the reasons for a bargain purchase. Without these disclosures, the FASB is concerned that there may be reasons to expect the existence of measurement errors. That is, financial statement readers may be led to believe that any bargain purchase gain is due more to errors in measuring the fair value of acquired net assets than in actually effecting the transaction at a bargain price.

We examined disclosures related to 71 bargain purchase acquisition transactions that took place in 2009. Of these 71 transactions, 24 involved FDIC-assisted acquisitions of distressed commercial banks. The FDIC's involvement in a distressed-bank acquisition appears to be a valid reason for the existence of a bargain purchase. Of the 47 remaining non-bank bargain purchase transactions reviewed, we found reasons for bargain purchases disclosed in nineteen

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<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

cases. Reasons for nondisclosure were not clear. However, it is possible some of the bargain-purchase gains were not considered to be material. Also, it is possible that we may have missed some of the disclosures. In other cases, it would appear that firms may not fully understand this disclosure requirement. For example, statements such as the following were encountered on a number of occasions:

"The gain on bargain purchase resulted from the value of the identifiable net assets exceeding the value of the purchase consideration" (Astro-Med, Inc., SEC Form 10-K Annual Report, January 31, 2010, p. 44).

"Gain on acquisition of Kingstone Insurance Company of \$5,178,000 in 2009 is attributable to the bargain purchase which was a result of the excess of net assets acquired from KICO compared to the acquisition cost" (Kingstone Companies, Inc, SEC Form 10-K Annual Report, December 31, 2009, p. 24).

"The gain on bargain purchase resulted from the value of the identifiable net assets acquired exceeding the value of the purchase consideration" (Netezza Corp., SEC Form 10-K Annual Report, January 31, 2010, p. 72).

"Because the cost of the acquisition is less than the fair value of the net assets of the subsidiary acquired, the excess of the value of the net assets acquired over the purchase price have been ordered as a bargain purchase gain" (Sonosite, Inc., SEC Form 10-K Annual Report, January 31, 2009, p. 35.)

Each of these statements simply describes or characterizes the computation of the bargain-purchase gains. They do not explain, as required, why the acquired firm may have been willing to sell its net assets for less than their fair value.

Overall, compliance with new rules requiring disclosure of the reasons for bargain purchase acquisition transactions was uneven. Clearly, company managements need to do more work on this front.

In Exhibits 1 and 2 we provide reasons noted for the existence of bargain purchase gains. In Exhibit 1 we provide some of the disclosures noted for FDIC-assisted bank acquisitions. Exhibit 2 provides reasons for bargain purchases in the cases of the non-banks.



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**Exhibit 1: Disclosures of the Reasons for Bargain Purchase Gains in FDIC-assisted Bank Acquisitions**

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**1. City National Corp. (SEC Form 10-K Annual Report, December 31, 2009, p. A-28)**

"The Bank received approximately \$70.8 million in cash from the FDIC and recorded a receivable for an additional \$5.3 million expected to be received in 2010. . . . The Bank recognized a gain of \$38.2 million on the acquisition. The gain represents the amount by which the fair value of the assets acquired and consideration received from the FDIC exceeds the liabilities assumed."

**2. East West Bancorp, Inc. (SEC Form 10-K Annual Report, December 31, 2009, p. 117)**

"The net gain . . . is influenced significantly by the FDIC-assisted transaction process. Under the FDIC-assisted transaction process, only certain assets and liabilities are transferred to the acquirer and, depending on the nature and amount of the acquirer's bid, the FDIC may be required to make a cash payment to the acquirer. The Bank had a cash payment due from the FDIC for \$174.0 million as of November 6, 2009 of which \$62.0 million was received in January 2010. In the United Commercial Bank acquisition as shown in the table below, the book value of net assets transferred to the Bank was \$990.1 million. The after tax gain of \$291.5 million recognized by the Company is considered a bargain purchase transaction under ASC 805 *Business Combinations* since the total acquisition-date fair value of the identifiable net assets acquired exceeded the fair value of the consideration transferred."

**3. Evans Bancorp (SEC Form 10-K Annual Report, December 31, 2009, p. 70)**

"The Company recognized a pre-tax bargain purchase gain of \$0.7 million as a result of the acquisition. The gain was due primarily to the benefit of the FDIC loss share agreement. Additionally, the loan portfolio purchased was at a discount to market yields resulting in positive value to the loans acquired."

**4. First Citizens Bancshares (SEC Form 10-K Annual Report, December 31, 2009, p. 32)**

"The gains recorded on the 2009 Acquisitions represent the net of the fair values for assets acquired and liabilities assumed, adjusted for cash we received from the FDIC and for the benefits provided under the loss share agreements."

**5. New York Community Bancorp (SEC Form 10-K Annual Report, December 31, 2009, p. 108)**

"The net after-tax gain represents the excess of the estimated fair value of the assets acquired (including cash payments received from the FDIC) over the estimated fair value of the liabilities assumed and is influenced significantly by the FDIC-assisted transaction process. Under the FDIC-assisted transaction process, only certain assets and liabilities are transferred to the acquirer and, depending on the nature and amount of the acquirer's bid, the FDIC may be required to make a cash payment to the acquirer. As indicated in the preceding table, net liabilities of \$2.8 billion (i.e., the cost basis) were transferred to the Company in the AmTrust acquisition, and the FDIC made a cash payment to the Company of \$3.2 billion."

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**Exhibit 1: Disclosures of the Reasons for Bargain Purchase Gains in FDIC-assisted Bank Acquisitions (continued)**

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6. Tri City Bankshares Corp., (SEC Form 10-K Annual Report, December 31, 2009, p. 4)

"The Bank was the successful bidder for the Bank of Elmword ("Acquired Bank") through an FDIC-assisted purchase (the "Acquisition") that was consummated on October 23, 2009."

7. WestAmerica Bancorporation (12/31/2009, 10-K, pp. 61-62)

"The acquisition resulted in a gain due to County's impaired capital condition at the time of the acquisition." Also, on page 61, note the following: "As a result of the loss-sharing agreements with the FDIC, the Company recorded a receivable of \$129 million at the time of acquisition." Further, also on page 61: "The FDIC approved the Bank's bid upon reviewing three competing bids and determining the Bank's bid would be the least costly to the Deposit Insurance Fund."

8. Wilshire Bancorp, Inc. (SEC Form 10-K Annual Report, December 31, 2009, p. 72 and p. F-18)

"The FDIC placed Mirae under receivership upon Mirae's closure by the California Department of Financial Institutions ("DFI") at the close of business on June 26, 2009. The Bank purchased substantially all of Mirae's assets and assumed all of Mirae's deposits and certain other liabilities. Further, the Company entered into a loss sharing agreement with the FDIC in connection with the Mirae acquisition."

"As a result of the loss sharing agreement with the FDIC, the Company has recorded an indemnification asset from the FDIC based on the estimated value of the indemnification agreement of \$40.2 million at June 26, 2009."

9. Zion Bancorporation (SEC Form 10-K Annual Report, December 31, 2009, p. 60)

"Acquisition related gains were \$169.2 million which resulted from the Company's acquisition of failed banks from the FDIC with loss sharing agreements."

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**Exhibit 2: Disclosures of the Reasons for Bargain Purchase Gains in Non-bank Acquisitions**

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1. AGY Holding Corp. (SEC Form 10-K Annual Report, December 31, 2009, p. F-15)

"Management believes that the Company was able to negotiate a bargain purchase price as a result of the then prevailing economic environment and its access to the liquidity necessary to complete the acquisition."

2. Alamo Group (SEC Form 10-K Annual Report, December 31, 2009, p. 75)

The Company believes that it was able to acquire *Bush Hog* for less than the fair value of its assets because of (i) the Company's unique position as a market leader in this industry segment and (ii) the seller's intent to exit its *Bush Hog* operations. *Bush Hog* was an unprofitable venture, and the seller approached the Company in an effort to sell *Bush Hog* and exit the agricultural equipment manufacturing business that no longer fit its strategy. With the seller's intent to exit the agricultural manufacturing business segment and the Company's position as a market leader, the Company was able to agree on a favorable purchase price.

3. BFC Financial Corporation (SEC Form 10-K Annual Report, December 31, 2009, p. 179)

"While BFC has held a substantial equity position in Bluegreen for a number of years, BFC was given the opportunity to expand its ownership by purchasing shares of Bluegreen held by a competitor who desired to dispose of the shares. The purchase which increased BFC's ownership to a control level was made at what the Company believes was an attractive price and resulted in a bargain gain under GAAP."

4. Corning (SEC Form 10-K Annual Report, December 31, 2009, p. 125)

"The gain was primarily related to access to a stable and favorably priced supply of electricity under a long-term contract, the relative condition of property, plant and equipment in relation to replacement cost and the benefit of a net operating loss carryforward that the Company expects to be able to utilize based on its strategic plans for this business."

5. EDAC Technologies Corp. (SEC Form 10-K Annual Report, January 2, 2010, p. 20)

"The Company realized a gain on the acquisition since the seller was willing to sell at less than the fair value of the net assets sold in consideration for the continued employment of the workforce--the seller had incurred significant losses in this operation in prior years and reported that the sale comes as result of review and realignment of our production structure."

6. FirstCity Financial Corporation (SEC Form 10-K Annual Report, December 31, 2009, p. 80)

"The gain was largely driven by depressed market conditions in the radio broadcast industry, which allowed for an attractive acquisition price."

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**Exhibit 2: Disclosures of the Reasons for Bargain Purchase Gains in Non-bank Acquisitions (continued)**

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7. Flowers Foods, Inc. (SEC Form 10-K Annual Report, January 2, 2010, p. 31)

"We believe the gain on acquisition resulted from the seller's strategic intent to exit a non-core business operation."

8. GSI Technology, Inc. (SEC Form 10-K Annual Report, March 31, 2010, p. 75)

"The acquisition resulted in a bargain purchase as Sony had been incurring significant losses on an annual basis, had a minimal product offering, had only one customer and declining annual revenues at the time of the acquisition and was therefore motivated to sell the assets of its SRAM product line."

9. H.D. Supply, Inc. (SEC Form 10-K Annual Report, January 31, 2010, p. 85)

"On June 1, 2009, HD Supply acquired substantially all of the assets of ORCO Construction Supply, a former competitor of the White Cap business, out of bankruptcy, for approximately \$16 million. The total estimated fair value of the net assets acquired, net of liabilities assumed, at the date of the acquisition was \$18 million, resulting in a \$2 million bargain purchase gain, which is included in Other (income) expense, net in the Consolidated Statements of Operations."

10. Leucadia National Corp. (SEC Form 10-K Annual Report, December 31, 2009, p. 13)

"The Company believes it was able to acquire the remaining 50% equity interest at this distressed price because of the expected payment default on Keen's senior secured debt owed to the Company and the Company's \$105,000,000 preferred equity distribution in the event Keen was liquidated."

11. Manitex International, Inc., two bargain purchases (SEC Form 10-K Annual Report, December 31, 2009, pp. 87 and 90)

Badger acquisition: "Our initial view was that a favorable price had been negotiated due to there being no open market sale process due to the long standing relationship with Avis since 2000. In addition, Avis did not use any outside advisors for the transaction and needed to focus on its core (mainly automotive) businesses that were under significant pressure in the current economy. Our assessment and valuation of the acquisition utilized professional independent valuation advisors and tax advisors."

Terex Load King acquisition: "During the assessment of the processing of the Load King acquisition it became apparent that the transaction may result in a bargain purchase. This supported an initial view that a favorable price had been negotiated due to the transaction being completed with a motivated seller as Terex Corporation (Terex.) desired to restructure its operations and focus on core competencies. Additionally, although Terex employed an investment banker to solicit potential buyers, Manitex was the only bidder identified willing to consummate a transaction with terms attractive to Terex (i.e. the only bidder who was willing to purchase substantially all the assets of Load King)."

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**Exhibit 2: Disclosures of the Reasons for Bargain Purchase Gains in Non-bank Acquisitions (continued)**

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12. Millipore Corp. (SEC Form 10-K Annual Report, December 31, 2009, p. 92)

"Under the new accounting standards for business combinations, which were effective as of January 1, 2009, the acquisition resulted in a gain because the fair value of net assets acquired exceeded the purchase price. This was primarily attributable to the net operating loss carry-forwards that we recognized as deferred tax assets based on our ability to use them in the future. These deferred tax assets could not be utilized by Guava as a result of their operating losses."

13. NIC, Inc. (SEC Form 10-K Annual Report, December 31, 2009, p. 61)

"The acquisition resulted in a gain in part because of Deloitte's desire to designate a buyer for certain assets to be acquired from BearingPoint prior to the closing of all of the transactions contemplated under the Asset Purchase Agreement with BearingPoint and because NIC was one of the few companies in the eGovernment portal management industry with the requisite experience to be considered as a potential buyer."

14. Pernix Group, Inc. (SEC Form 10-K Annual Report, December 31, 2009, p. 30)

"The bargain purchase reflects the losses recently incurred due to the difficult global economy coupled with the need for a strong management team with industry expertise, strong international and governmental project management and engineering skills."

15. Preformed Line Products Co. (SEC Form 10-K Annual Report, December 31, 2009, p. 66)

"The Company was able to realize a gain on acquisition of business as a result of current market conditions and the seller's desire to exit the business. The gain on acquisition of business is recorded on the face of the Statement of Consolidated Income within other income (expense)."

16. Radnet, Inc. (SEC Form 10-K Annual Report, December 31, 2009, p. 40)

"We believe that the gain on bargain purchase resulted from various factors that impacted the sale of those New Jersey assets. The seller was performing a full liquidation of its assets for the benefit of its creditors. Upon liquidation of all of its assets, the seller intended to close its business. The New Jersey assets were the only remaining assets to be sold before a full wind-down of the seller's business could be completed. We believe that the seller was willing to accept a bargain purchase price from us in return for our ability to act more quickly and with greater certainty than any other prospective acquirer. The decline in the credit markets made it difficult for other acquirers who relied upon third party financing to complete the transaction. The relatively small size of the transaction for us, the lack of required third-party financing and our expertise in completing similar transactions in the past gave the seller confidence that we could complete the transaction expeditiously and without difficulty."

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**Exhibit 2: Disclosures of the Reasons for Bargain Purchase Gains in Non-bank Acquisitions (continued)**

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17. Republic Airways Holding (SEC Form 10-K Annual Report, December 31, 2009, pp. 62-63)

"Management believes that the significant gain on bargain purchase from the acquisition of Frontier is due primarily to the following factors:

1. Republic was the largest unsecured creditor with a claim of \$150.0 million and Republic would have received a significant portion of any payment made to the pool of unsecured creditors if another bidder would have successfully outbid Republic during the auction process.
2. Frontier was in bankruptcy and operates in a heavily regulated industry.
3. The airline industry is highly volatile and subject to significant fluctuation in one of its largest expenses, aircraft fuel.
4. The Denver market is highly competitive.
5. The illiquidity in the credit market may have kept other bidders from potentially coming forward to bid against Republic in the auction process because of their inability to obtain financing.
6. General recessionary economy
7. There was only one other bidder in the auction process and their bid became nonbinding.
8. Frontier has significant net operating losses, net of Section 382 limitations, that Republic will be able to apply to future taxable income.
9. Frontier has a significant amount of operating leases that require significant cash flows for several years and the operating leases have return conditions that well potentially require significant cash flow at the end of the leases.
10. The aircraft acquired are used aircraft and therefore will require more maintenance in future periods.
11. The acquired business is expected to generate losses from continued operations for several months.

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**Exhibit 2: Disclosures of the Reasons for Bargain Purchase Gains in Non-bank Acquisitions (continued)**

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18. Superior Energy Services, Inc. (SEC Form 10-K Annual Report, December 31, 2009, p. 13)

"The Company's estimate of the net assets' fair value exceeded the estimated fair value of the total consideration paid which management believes resulted from the Predecessor's financial difficulties."

19. Warwick Valley Telephone Co. (SEC Form 10-K Annual Report, December 31, 2009, p. 31)

"The seller, US Datanet, was in bankruptcy under Chapter 11, and its assets were sold under a court approved sale."

**Insights from the Disclosed Reasons for Bargain Purchase Gains**

A review of the reasons that acquiring firms identify as creating bargain purchase gains yields a variety of items. In the bank-related transactions, it was clear that the FDIC's assistance in the acquisitions of distressed banks led to the observed bargain purchase gains. Every bargain purchase bank transaction included in Exhibit 1 made mention of the FDIC's involvement. In terms of the non-bank acquisitions, our findings in Exhibit 2 are summarized in Exhibit 3.



**Exhibit 3: Disclosed Reasons for Bargain Purchase Gains in Non-Bank Acquisitions**

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## Related to Financial Distress of Target Firm

1. Business acquired out of bankruptcy (Chapter 11) or in bankruptcy
2. Distressed company
3. Motivated seller
4. Acquired firm incurring operating losses; impaired capital position; consuming cash
5. Depressed market conditions
6. Difficult global economy
7. Seller liquidating assets to benefit creditors

## Related to Tax Benefits Available to Acquiring Firm

8. Net operating loss tax benefits that can be realized by the acquiring firm--net of Sec. 382 limitations

## Related to Characteristics of Acquiring Firm

9. Good fit with the selling firm's needs
10. Willingness to purchase all assets
11. Experience of the potential buyer in the business or in completing similar transactions
12. Lack of a need for third-party financing
13. Acquiring firm can act quickly with greater certainty

## Related to Flaws in the Bidding Process

14. Assets acquired last in the way of a close down
15. Sale not an open market process
16. Only one other bidder in the auction process
17. Market illiquidity kept other bidders from bidding
18. Acquired firm does not use outside advisors; acquiring firm does

## Related to Changes in Business Strategy of Target Firm

19. Business no longer fits--strategic focus on core business

## Related to the Nature of the Business of Target Firm

20. A difficult business to operate

## Related to Special Factor

21. Acquiring firm supports continued employment of workforce

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Note: This Exhibit summarizes the reasons for bargain purchase gains in non-bank acquisitions provided in Exhibit 2.

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In Exhibit 3 we summarize the reasons disclosed for bargain purchase gains in non-bank acquisitions. The first seven items listed in Exhibit 3 share the common theme of financial distress of the target firm, including bankruptcy, a motivated seller, operating losses, depressed market conditions, a difficult economy and the need to sell assets to benefit creditors. Item 8 from Exhibit 3, the tax benefit item, also an item related to the financial distress, arises because the target has accumulated operating losses that provide tax benefits against future profits that it likely will not be able to use. A profitable acquiring firm, however, may be able to use them, subject to certain limits found in Section 382 of the Internal Revenue Code. Disclosures about the financial distress of the target, whether in the form of current or past losses, could raise questions about the target's future financial success or the ultimate ability of the acquiring firm to successfully integrate the target's business.

Items 9 through 13 in Exhibit 3 relate to characteristics of the acquiring firm, including its fit with the target or its willingness to purchase all of the target's assets, its experience in the target's business or in completing similar transactions, the lack of a need for third-party financing, or the speed with which the acquiring firm can effect the transaction. Items 14 through 18 relate to flaws in the bidding process, such as the lack of other bidders or a failure of the target to use an outside advisor, which may have led to a discounted price. All of the items, numbers 9 through 18, relate more to price than to quality and are less likely to call into question the future operating success of the target's business than do items 1 through 8.

Items 19 and 20 from Exhibit 3 relate in one way or another to the target's business. In item 19, given a change in strategy, a target may become a motivated seller, offering an interested buyer an opportunity to purchase a viable asset at a discounted price. In contrast, in item 20, it would appear that the target is having difficulty operating its business, possibly due to the economy or industry. However, difficulty in operating a business could entail any number of problems, including labor, supply or distribution. Whether the buyer would have similar difficulties would be an open question at the time of purchase and one that investors would want to answer.

Some acquiring firms offer special factors that may result in a favorable price. In item 21, a discounted price was negotiated because the acquiring firm supports the continued employment of the target's workforce. The enforceability of that agreement was not clear. Nor was it clear whether employing the full workforce of the target would impact its profitability in a negative way – another open issue that an investor would want to clarify.

## Summary and Conclusions

The issuance of a revised version of SFAS No. 141, *Business Combinations*, introduced some significant changes in the accounting for acquisitions as well as their associated disclosures. Under generally accepted accounting principles, as revised, bargain-purchase amounts (previously referred to as negative goodwill) are no longer set off against the fair value of acquired assets but are reported as gains within income from continuing operations. This change clearly improves the representational faithfulness of the balance sheet by recording acquired assets at their fair value. The quality of the valuations assigned to acquired net assets should also improve as the revised accounting standard calls for a reassessment by the acquirer to determine, among other things, "whether it has correctly identified all of the assets acquired and all of the liabilities assumed and shall recognize any additional assets or liabilities that are identified in that review."<sup>16</sup>

In the presence of bargain purchase gains, SFAS No. 141(R) will affect the financial statements in other ways. For example, because the full amount of bargain purchase gains will be recognized, earnings volatility will be increased. Further, as assets are valued at higher amounts, reflecting fair value, shareholders' equity will be increased and measures of financial leverage will be reduced. In years following an acquisition, operating earnings will be reduced as the amortization of higher asset values increases operating expense.

Beyond the income statement and balance sheet effects of SFAS No. 141 (R), new information on why bargain purchase gains were obtained is now provided. In reviewing 71 bargain purchase acquisitions in 2009, we noted several general explanations for the existence of bargain purchases. Many of the transactions reviewed were acquisitions of distressed banks, entailing FDIC assistance and the realization of a bargain purchase gain by the acquiring bank. In examining the non-bank acquisitions, several other factors, ranging from financial distress of the target, to special characteristics of the acquiring firm, to flaws in the bidding process, led to the existence of bargain purchase gains.

Investors will want to take note of the reasons that firms attribute for the existence of bargain purchase gains to better evaluate the likelihood of success of a target's future operations. Under new rules, CFOs and other corporate managers should be prepared to report higher gains in the year of a bargain purchase and lower earnings in subsequent years. Assets and shareholders' equity will be reported at higher valuations.

The year 2009 was the first year in which the provisions of SFAS No. 141 (R) were effective. In terms of new disclosures related to bargain purchase acquisitions, the results are mixed. In particular, for example, we found that only 19 of 47 non-banks effecting bargain purchase transactions disclosed the reasons for the bargain purchase gains as required by generally

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<sup>16</sup> SFAS No. 141(R), paragraph 38.

accepted accounting principles. The open question for regulators, such as the FASB and SEC, is whether compliance with the new requirement improves as firms have more time to implement the new standard.